In the Supreme Court of the United States

OCTOBER TERM, 1974

No. 74-1173

SHIRLEY KLEIN, ETC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

The sole question presented by the petition is whether the grant of an exclusive license to certain patent rights within a limited geographical area was a transfer of "all substantial rights to a patent" within the meaning of Section 1235(a) of the Internal Revenue Code of 1954, so that the royalty payments under the license agreement qualified for long-term capital gains treatment.

The pertinent facts are as follows: In 1956, George T. Klein[1] ("George") obtained a patent relating to a process for converting organic waste into fertilizer (Pet. App. A 16; Pet. App. B 27). Four years later, George entered into an agreement with Organic Compost Corporation of Pennsylvania, granting that company the exclusive rights to manufacture, sell, and use the patented product in all or parts of 13 eastern states

[1]George T. Klein is now deceased. His wife, Shirley Klein, is the petitioner in her capacity as executrix of his estate and in a personal capacity because she filed joint income tax returns with her husband for the years at issue.

and the District of Columbia (Pet. App. A 17-20; Pet. App. B 27-28). Under the agreement, George was to receive a minimum annual royalty of $7,500, plus additional royalties equal to a percentage of gross sales of organic compost (Pet. App. A 17-18; Pet. App. B 28).

For the years 1966 through 1968, George reported the royalty receipts under the agreement as long-term capital gain under Section 1235 of the Code. That provision permits a transfer of "all substantial rights to a patent or an undivided interest therein" by a "holder" to be treated as a sale or exchange of a capital asset held for more than six months, whether or not the transaction would otherwise qualify for such treatment.

On audit, the Commissioner determined that the income from the agreement was taxable to George at ordinary income rates. He based this determination upon Section 1.1235-2(b)(1)(i) of the Treasury Regulations, which provides that the transfer of patent rights within a geographically limited area is neither a transfer of "all substantial rights to a patent" nor a transfer of "an undivided interest" in all such substantial patent rights within the meaning of Section 1235 (Pet. App. A 23). The Tax Court concluded that the Treasury Regulation upon which the Commissioner relied was invalid, and held that the transaction qualified for long-term capital gain tax treatment under Section 1235 (Pet. App. A 15-26). The court of appeals reversed and remanded, upholding the Regulations (Pet. App. B 27-35).

1. Section 1235(a) of the Code gives inventors and certain other patent holders long-term capital gain treatment on the transfer of "property consisting of all substantial rights to a patent, or an undivided interest therein." By making long-term capital gain treatment available even though the consideration for

the transfer may be based on productivity or use of the patent, Congress intended to resolve judicial and administrative uncertainties which had arisen with respect to the taxation of royalty-type payments in patent licensing arrangements. S. Rep. No. 1622, 83d Cong., 2d Sess., 113-114, 438-441 (1954); see *United States* v. *Zacks*, 375 U.S. 59, 62-63.

However, the threshold requirement of Section 1235 is that the transfer encompass "all substantial rights to a patent" or "an undivided interest therein." In defining these terms, the pertinent Treasury Regulations under Section 1235 provide that the term "all substantial rights to a patent" includes "all rights (whether or not then held by the grantor) which are of value at the time the rights to the patent * * * are transferred" and specifically exclude from such definition four categories of limited transfers: (1) grants "limited geographically within the country of issuance"; (2) grants "limited in duration * * * to a period less than the remaining life of the patent"; (3) grants "in fields of use within trades or industries, which are less than all the rights covered by the patent, which exist and have value at the time of the grant"; and (4) grants of "less than all the claims or inventions covered by the patent which exist and have value at the time of the grant." Treasury Regulations, Section 1.1235-2(b)(1). Section 1.1235-2 (c) of the Regulations further provides that none of such limited transfers of patent rights constitutes a transfer of an "'undivided interest' in all substantial rights to a patent."

Here, it is undisputed that petitioner's transfer of patent rights to Organic Compost Corporation did not qualify for Section 1235 treatment under the Treasury Regulations. His transfer was limited to the rights to exploit the patent only within 13 states and the District of Columbia, and the rights he retained to exploit the patent in other parts of the country had substantial value.

Petitioner argues (Pet. 7) that the Regulations are invalid on the ground that Congress intended Section 1235 treatment to apply to all patent transfers, including those transfers of geographically limited patent rights which would qualify as assignments of patent rights, rather than mere licenses, under general patent law principles. See *Waterman* v. *Mackenzie*, 138 U.S. 252. Although this patent law principle has been deemed relevant to the question whether a transfer of a limited or divided interest in a patent might qualify as a "sale or exchange" under Code provisions other than Section 1235,[2] petitioner's contention that such a limited transfer of patent rights also qualified under Section 1235 is at odds with the "all substantial rights" qualification of that provision, as well as the clear expression of legislative intent by the Senate Finance Committee at the time of its enactment (S. Rep. No. 1622, *supra*, at 439). The Committee Report stated (*ibid.*):

> By "undivided interest" a part of each property right represented by the patent (constituting a fractional share of the whole patent) is meant (and not, for example, a *lesser interest* such as a right to income, or a *license limited geographically*, or a license which conveys some, but not all, of the claims or uses covered by the patent). [Emphasis added.]

This statement sets forth the Committee's understanding of the statutory term "undivided interest." However, it applies with equal force to the term "all substantial rights." The Committee would not have cited examples of transfers which would not qualify as transfers of an "undivided interest" in all substantial patent rights if it intended that those transfers would have qualified for Section 1235 treatment in any event as transfers of "all substantial rights to a patent."

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[2]See, *e.g.*, *E.I. duPont de Nemours and Co.* v. *United States*, 432 F.2d 1052 (C.A. 3); *Merck & Co.* v. *Smith*, 261 F.2d 162 (C.A. 3); and *Redler Conveyor Co.* v. *Commissioner*, 303 F.2d 567 (C.A. 1). Although petitioner urges (Pet. 12-13) that these cases conflict with the decision below, none of them involved the claim that a patent transfer qualified under Section 1235.

2. As petitioner concedes (Pet. 11), the decision below is in accord with the other courts of appeals. See *Fawick* v. *Commissioner*, 436 F.2d 655 (C.A. 6), reversing 52 T.C. 104, and *Mros* v. *Commissioner*, 493 F.2d 813 (C.A. 9), reversing *per curiam*, P-H Memo T.C., par. 71,123.[3] While those cases involved transfers of patents within limited fields of use, they upheld the validity of the same Regulations at issue here. The court of appeals in the present case similarly correctly sustained those Regulations, which find direct support in the terms of the statute and the legislative history with respect to patent transfers of limited geographical use. See, *e.g.*, *Commissioner* v. *South Texas Co.*, 333 U.S. 496, 501.

For the reasons stated, it is respectfully submitted that the petition for a writ of certiorari should be denied.

ROBERT H. BORK,
Solicitor General.

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[3]The Ninth Circuit noted in *Mros* that the portion of the Regulations dealing with transfers of patent rights within limited fields of use is itself consistent with the general principles of patent law (see *Redler Conveyor Co.* v. *Commissioner*, *supra*) as well as with the language and legislative history of Section 1235. However, the court there did not hold, or even suggest, that a transfer which would qualify as an assignment under *Waterman* v. *Mackenzie*, *supra*, would also necessarily qualify as a transfer of "all substantial rights to a patent" under Section 1235. Thus, contrary to petitioner's contention (Pet. 13-14), the decision below does not conflict with *Mros*.